



## Regulatory Update — SEC Proposes Amendments to its Broker-Dealer Financial Responsibility Rules

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### SCHIFF HARDIN LLP

6600 Sears Tower  
Chicago, IL 60606

t 312.258.5500  
f 312.258.5600

1666 K Street, N.W.  
Suite 300  
Washington, DC 20006

t 202.778.6400  
f 202.778.6460

623 Fifth Avenue  
28<sup>th</sup> Floor  
New York, NY 10022

t 212.753.5000  
f 212.753.5044

One Atlantic Center  
Suite 2300  
1201 West Peachtree  
Atlanta, GA 30309

t 404.806.3800  
f 404.806.3801

One Westminster Place  
Lake Forest, IL 60045

t 847.295.9200  
f 847.295.7810

One Market  
Spear Street Tower  
Thirty-Second Floor  
San Francisco, CA 94105

t 415.901.8700  
f 415.901.8701

[www.schiffhardin.com](http://www.schiffhardin.com)

## Summary of Proposed Amendments

### I. Background

On March 9, 2007, the Securities and Exchange Commission ("SEC") published a proposal to amend several of the rules it administers pursuant to its financial responsibility program for broker-dealers.<sup>1</sup> Generally, the SEC's financial responsibility program for broker-dealers is designed to enhance investor confidence in the financial integrity of securities firms. It does this by requiring that broker-dealers safeguard funds and securities, keep and maintain accurate books and records, and maintain sufficient liquid assets in excess of liabilities such that a broker-dealer that fails can be liquidated in an orderly manner without the need for a formal proceeding.

The substantive rules addressed in the Release are: (1) Exchange Act Rule 15c3-1 (the "net capital rule"); (2) Exchange Act Rule 15c3-3 (the "customer protection rule"); (3) Exchange Act Rules 17a-3 and 17a-4 (the "books and records rules"); and (4) Exchange Act Rule 17a-11 (the "notification rule"). The proposal is intended to address several emerging areas of concern regarding the financial requirements for broker-dealers, to update the financial responsibility rules, and to make certain technical amendments. The SEC has requested comments on the proposed amendments by May 18, 2007.

Set forth below is a summary of the SEC's proposed amendments. Certain additional topics on which the SEC seeks comment also are discussed.

### II. The Net Capital Rule

#### A. Overview of the Net Capital Rule

The net capital rule prescribes minimum liquidity standards for broker-dealers, requiring broker-dealers to maintain certain specified levels of net capital. For example, broker-dealers that engage in a general securities business are required to maintain a minimum net capital of \$250,000. In addition, broker-dealers also must meet one of two financial ratios. Broker-dealers that elect the basic financial ratio (*i.e.*, "basic standard" firms) may not allow their aggregate indebtedness (*i.e.*, the broker-dealer's liabilities, with certain exclusions) to exceed 1500% of their

net capital. Broker-dealers that elect the alternative financial ratio (*i.e.*, "alternative standard" firms) must maintain, in addition to the \$250,000 minimum net capital requirement, net capital of at least 2% of their aggregate debit items (*i.e.*, monies owed the broker-dealers by their customers) computed in accordance with the "Formula for Determination of Reserve Requirements for Brokers and Dealers" (the "Reserve Formula") under the customer protection rule. The net capital rule also describes how to compute net capital.

In determining net capital, a broker-dealer first computes its net worth in accordance with generally accepted accounting principles and then adds to this amount certain subordinated liabilities. From that figure, the broker-dealer subtracts assets not readily convertible into cash, such as fixed assets and most unsecured receivables. The broker-dealer then subtracts prescribed percentages of the market value (otherwise known as "haircuts") of securities owned by the broker-dealer to discount for market movement. The resulting figure is the broker-dealer's net capital, a figure that reflects the current liquidity status of the broker-dealer (*i.e.*, its ability to pay promptly all of its liabilities).

#### B. Proposed Amendments to the Net Capital Rule

##### 1. Expense Sharing Arrangements

The SEC expressed concern in the Release that some broker-dealers, when computing net capital, may be excluding from their calculations certain liabilities that relate directly to expenses or debts incurred by the broker-dealer, but which are assumed by a third-party (usually a parent or an affiliate) that does not have the resources – independent of the broker-dealer's revenues and assets – to assume the liabilities. According to the SEC, excluding these liabilities from the broker-dealer's net worth calculation may misrepresent the broker-dealer's actual financial condition, deceive the firm's customers, and hamper the ability of regulators to monitor the firm's financial condition.

To address this concern, the SEC proposed to require a broker-dealer to adjust its net worth when calculating net capital by including any liabilities that are assumed by a third-party if the broker-dealer cannot demonstrate (*e.g.*, through recent and current audited financial statements, tax returns, and/or regulatory filings) that the third-party has the resources independent of the broker-dealer's income

<sup>1</sup> See Securities Exchange Act of 1934 ("Exchange Act") Release No. 55431 (March 9, 2007), 72 FR 12862 (March 19, 2007) (the "Release"), available at <http://www.sec.gov/rules/proposed/2007/34-55431.pdf>.

and assets to pay the liabilities. This proposal would, in large part, codify an existing SEC staff position.<sup>2</sup>

## 2. Temporary Capital Contributions

The SEC also expressed concern that broker-dealers may be receiving capital contributions from individual investors that are subsequently withdrawn after a short period of time (often less than a year), sometimes under an agreement giving the investor the option to withdraw the capital at the investor's discretion. The SEC has previously emphasized that capital contributions to broker-dealers should not be temporary,<sup>3</sup> and the SEC staff has explained that a capital contribution should be treated as a liability if it is made with the understanding that the contribution can be withdrawn at the option of the investor.<sup>4</sup>

To address this concern, the SEC proposed that a broker-dealer must treat as a liability (i) any capital that is contributed under an agreement giving the investor the option to withdraw the capital; and (ii) any capital contribution that is intended to be withdrawn within a year unless the broker-dealer receives permission in writing from its designated examining authority ("DEA").

## 3. Fidelity Bond Deduction

Under self-regulatory organization ("SRO") rules, certain broker-dealers (*e.g.*, those doing business with the public and members of the Securities Investor Protection Corporation ("SIPC")) must comply with mandatory fidelity bonding requirements to protect their capital from certain unforeseen losses (*e.g.*, losses arising from improper activity of an employee). SRO rules typically permit a broker-dealer to have a deductible provision included in the fidelity bond, which may not exceed certain amounts. With regard to firms that maintain deductible amounts over the maximum amount permitted, a number of SRO rules

<sup>2</sup> See Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Elaine Michitsch, Member Firm Regulation, NYSE, and Susan DeMando, Director, Financial Operations, NASD (July 11, 2003), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/macchiaroli071103.pdf>.

<sup>3</sup> See *Study of Unsafe and Unsound Practices of Broker-Dealers, Report and Recommendations of the Securities and Exchange Commission*, H.R. Doc. No. 92-231 (1971).

<sup>4</sup> See Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Raymond J. Hennessy, Vice President, NYSE, and Susan DeMando, Vice President, NASD Regulation, Inc. (Feb. 23, 2000), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/nysenasd022300-out.pdf>.

require a broker-dealer to deduct this excess amount from net worth when calculating net capital. The net capital rule, however, does not specifically reference these deductions, meaning that a broker-dealer would not be required to show the impact of the deduction in the broker-dealer's net capital computation on the periodic FOCUS reports it files with regulators.

To address this gap, the SEC proposed to amend the net capital rule to require broker-dealers subject to capital charges under SRO rules for excess fidelity bond deductibles to include such charges in their net capital computations under the net capital rule.

## 4. Broker-Dealer Solvency Requirement

According to the SEC, a broker-dealer that has made an admission of insolvency, or is otherwise deemed insolvent or entitled to protection from creditors, does not possess the financial resources necessary to operate a securities business, and poses a risk to customers, counterparties, creditors, and the securities clearance and settlement system.

To prevent a broker-dealer from continuing to conduct a securities business while insolvent or seeking bankruptcy protection, the SEC proposed to define the term "insolvent" in the net capital rule and to require a broker-dealer to cease its securities business activities if certain insolvency events occur. "Insolvent" would be broadly defined as, among other things, (i) a broker-dealer's placement in a voluntary or involuntary bankruptcy or similar proceeding; (ii) the appointment of a trustee, receiver or similar official; (iii) a general assignment by the broker-dealer for the benefit of its creditors; (iv) an admission of insolvency; or (v) the inability to make computations necessary to establish compliance with the net capital rule. Rule 17a-11 also would be amended to require a broker-dealer meeting the definition of the term "insolvent" in the net capital rule to provide immediate notice to the SEC, the broker-dealer's DEA, and, if applicable, the Commodity Futures Trading Commission (the "CFTC").

## 5. Orders Restricting Capital Withdrawals

Paragraph (e)(3) of Rule 15c3-1 provides that the SEC may issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to stockholders, insiders, and affiliates under circumstances that may be detrimental to the financial integrity of the broker-dealer, may unduly jeopardize the firm's ability to repay its customer claims or other liabilities, or may cause

a significant impact on the markets.<sup>5</sup> The rule, however, limits such orders to withdrawals, advances, or loans that, when aggregated with all other withdrawals, advances, or loans on a net basis during a 30 calendar day period, exceed 30% of the firm's excess net capital.<sup>6</sup> An order under paragraph (e)(3) may restrict withdrawals, advances, or loans for a period of up to 20 business days.

The SEC stated in the Release that it has found that the books and records of troubled broker-dealers are often incomplete or inaccurate, which can make it difficult to determine a firm's actual net capital and excess net capital amounts. In such cases, an SEC order limiting a broker-dealer's ability to withdraw a percentage of its excess net capital would be difficult to enforce as it would not be clear when that threshold was reached. For this reason, the SEC proposed to amend paragraph (e)(3) of Rule 15c3-1 to allow the SEC to restrict all withdrawals, advances, and loans for a period of up to 20 business days, rather than only those that exceed 30% of the broker-dealer's excess net capital.

#### 6. Haircuts on Money Market Funds

In the Release, the SEC proposed to reduce the haircut broker-dealers are required to apply to proprietary positions in money market funds described in Rule 2a-7 under the Investment Company Act of 1940 (the "Investment Company Act"), from 2% to 1%. This proposal is designed to better align the net capital treatment of money market funds with the risk associated with such investments. In the Release, the SEC noted that money market funds have been historically stable investments, helped in part by the risk limiting investment restrictions in Rule 2a-7, which was adopted by the SEC after the 2% haircut was imposed.

#### 7. Haircuts on Certain Currency and Index Options

In 1997, the SEC adopted amendments to Appendix A of the net capital rule that permitted broker-dealers to employ theoretical option pricing models to calculate net capital for listed options and related positions that hedge those options.<sup>7</sup> When adopting these amendments, the SEC

reduced the net capital haircuts applicable to proprietary listed options positions of non-clearing option specialists and market-makers in major market foreign currencies and high-capitalization and non-high-capitalization diversified indexes. The SEC provided that this relief, codified in paragraph (b)(1)(iv) of Appendix A, would expire two years from its effective date unless it could be demonstrated that retention of the reduced haircuts was in the public interest. The SEC staff, by no-action letter dated January 13, 2000, temporarily extended the relief in paragraph (b)(1)(iv) "until such time as the SEC has determined whether [the relief] should be extended."<sup>8</sup>

In the Release, the SEC stated that despite periods of substantial volatility, there have been no significant increases in the number of deficits in non-clearing option specialist and market-maker accounts, nor did the lower capital charges in paragraph (b)(1)(iv) result in excessive leverage. Consequently, the SEC proposed to make permanent the temporary rule, which would continue to allow broker-dealers carrying non-clearing option specialist and market maker accounts to apply reduced haircuts for positions in those accounts in major market foreign currencies and diversified indexes.

#### 8. Securities Lending and Repo Transactions

According to the SEC, uncertainty as to whether broker-dealers are acting as principal or agent in a securities lending transaction raises concerns as to whether broker-dealers are taking required net capital charges related to their securities lending activities.<sup>9</sup> For example, a broker-dealer might not take the required charges on the theory that it was arranging the loans as agent, rather than as principal, notwithstanding the fact that there was no express disclaimer of principal liability.

To improve regulatory oversight of securities lending and repo transactions, the SEC proposed to amend paragraph (c)(2)(iv)(B) of Rule 15c3-1 to clarify that broker-dealers providing securities lending settlement services are

<sup>5</sup> The SEC noted in the Release that it has only once issued an order restricting a broker-dealer from withdrawing capital since paragraph (e)(3) was adopted in 1991, which was an October 13, 2005 order involving two broker-dealer subsidiaries of REFCO, Inc.

<sup>6</sup> "Excess net capital" is the amount that a broker-dealer's net capital exceeds its minimum net capital requirement.

<sup>7</sup> See Exchange Act Release No. 38248 (Feb. 6, 1997), 62 FR 6474 (Feb. 12, 1997), available at <http://www.sec.gov/rules/final/34-38248.txt>.

<sup>8</sup> Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Richard Lewandowski, Vice President, Regulatory Division, The Chicago Board Options Exchange, Inc. (Jan. 13, 2000), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/cboe011300-out.pdf>.

<sup>9</sup> Whether certain broker-dealers were acting as principals or agents has been the subject of recent litigation involving MJK Clearing, Inc., the largest liquidation under the Securities Investor Protection Act of 1970 to date.

assumed, for purposes of the net capital rule, to be acting as principals and are subject to applicable net capital deductions. Under the proposed amendment, the deductions could be avoided if a broker-dealer takes certain steps to disclaim principal liability, such as disclosing the identities of the borrower and lender to each other and obtaining written agreements from the borrower and lender stating that the broker-dealer is acting exclusively as agent and assumes no principal liability in connection with the transaction.

To help the SEC identify broker-dealers with highly leveraged non-governmental securities lending and repo operations and to make it easier for regulators to respond more quickly and protect customers in the event a firm is approaching insolvency, the SEC also proposed to add paragraph (c)(5) to Rule 17a-11. This rule, if adopted, would require broker-dealers to notify the SEC whenever the total amount of money payable against all securities loaned or subject to a repurchase agreement, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement, exceeds 2,500% of tentative net capital.<sup>10</sup> For purposes of this leverage threshold, transactions involving government securities would be excluded from the calculation.

### III. The Customer Protection Rule

#### A. Overview of the Customer Protection Rule

The customer protection rule was adopted in 1972 to protect customer funds and securities held by broker-dealers. In general, the customer protection rule has two parts, which apply to broker-dealers not exempt from the rule. The first part requires a broker-dealer to have possession or control of all fully paid and excess margin securities of their customers.<sup>11</sup> In this regard, a broker-dealer must make a daily determination to ensure that it is complying with this aspect of the rule.

The second part covers customer funds and requires each broker-dealer to make a periodic computation to determine

<sup>10</sup> "Tentative net capital" is a broker-dealer's net capital prior to applying securities haircuts.

<sup>11</sup> Subparagraph (a)(3) of Rule 15c3-3 defines "fully paid securities" as securities carried in any type of account for which the customer has made full payment. Subparagraph (a)(5) defines "excess margin securities" as securities having a market value in excess of 140% of the amount the customer owes the broker-dealer and which the broker-dealer has designated as not constituting margin securities.

how much money it is holding that is either customer money or money obtained from the use of customer securities ("credits"). From that figure, the broker-dealer subtracts the amount of money which it is owed by customers or by other broker-dealers relating to customer transactions ("debits"). If the credits exceed debits, the broker-dealer must deposit the excess in a Special Reserve Bank Account for the Exclusive Benefit of Customers (a "Reserve Account"). If the debits exceed credits, no deposit is necessary. Funds deposited in a Reserve Account cannot be withdrawn until the broker-dealer completes another computation that shows that the broker-dealer has on deposit more funds than the Reserve Formula requires.

The customer protection rule is designed to prevent broker-dealers from using customer money to finance their business, except as related to customer transactions, since customer monies (the credits) can be offset only by customer related transactions (the debits). As a result, broker-dealers must provide the capital to finance their trades and firm activities and may not use customers' monies left with them for such purposes.

#### B. Proposed Amendments to the Customer Protection Rule

##### 1. Proprietary Accounts of Broker-Dealers

To correct a definitional gap between the term "customer" as defined in the customer protection rule and in the Securities Investor Protection Act of 1970 ("SIPA"),<sup>12</sup> and to mitigate against potential contagion that might arise in the event of a failure of a broker-dealer with a large number of broker-dealer customers, the SEC proposed to require a carrying broker-dealer to perform a separate reserve computation for proprietary accounts it holds of other domestic and foreign broker-dealers (referred to in the Release as "PAB" accounts) in addition to the reserve computation currently required for customer accounts.

<sup>12</sup> Broker-dealers – which are not typically treated as customers under Rule 15c3-3, but are so treated under SIPA – are entitled to a *pro rata* share of the estate of customer property in a SIPA liquidation. This means that under Rule 15c3-3, broker-dealers that carry the proprietary accounts of other broker-dealers are not required to include credit and debit items associated with those accounts in the Reserve Formula, and, as a result, there is a greater possibility that the SIPC Fund, established under SIPA, will have to be utilized to protect customers (other than broker-dealers, who are not entitled to advances from the SIPC Fund). Resources are made available to customers from the SIPC Fund when property in a failed broker-dealer's possession is insufficient to make up for missing cash and securities.

Under the proposal, a carrying broker-dealer would have to establish and maintain a Reserve Account at a bank for PAB accounts, and, if required after the PAB reserve computation, would have to deposit cash and/or qualified securities in the account equal to at least the PAB reserve requirement. With regard to broker-dealers whose proprietary accounts are carried by other broker-dealers, the net capital rule would require the proprietary account owner to deduct from net worth when calculating net capital the amount of cash in its proprietary account at the carrying broker-dealer if the carrying broker-dealer is not treating the cash in compliance with the PAB reserve requirements. This proposal would codify an existing SEC staff position,<sup>13</sup> and broaden the scope of that position by including proprietary accounts of foreign broker-dealers and banks acting as broker-dealers.

## 2. Banks Where Reserve Account Deposits May Be Held

A broker-dealer's cash deposits at a bank are fungible with other deposits carried by the bank and may be freely used in the course of the bank's commercial lending activities. Thus, to the extent a broker-dealer deposits cash in a Reserve Account, there is a risk the cash could be lost or become inaccessible for a period of time if the bank experiences financial difficulties. This could adversely impact the broker-dealer and its customers if the balance in the Reserve Account is concentrated at one bank in the form of cash. This risk may be heightened when the deposit is held at an affiliated bank in that the broker-dealer may not exercise due diligence with the same degree of impartiality when assessing the financial soundness of an affiliated bank as it would with a non-affiliate bank.

To address this risk, the SEC proposed to require broker-dealers to exclude cash deposits at affiliate banks for purposes of meeting customer or PAB reserve requirements. The SEC also proposed to limit the amount of cash a broker-dealer can maintain in a customer or PAB Reserve Account at one unaffiliated bank by requiring a broker-dealer to exclude a Reserve Account deposit to the extent that it exceeded 50% of the broker-dealer's excess net capital (based on the broker-dealer's most recent FOCUS Report) or 10% of the bank's equity capital (based

on the bank's most recently filed Call Report or Thrift Financial Report).

## 3. Expanding the Definition of "Qualified Securities"

A broker-dealer is limited to depositing cash or "qualified securities" into a Reserve Account to meet the reserve deposit requirements under the customer protection rule. "Qualified securities" are defined in the customer protection rule as securities issued by the United States or guaranteed by the United States with respect to principal and interest ("U.S. Treasury Securities"). In response to a petition for rulemaking by Federated Investors, Inc.,<sup>14</sup> the SEC proposed to expand the types of assets that can be used to fund a broker-dealer's Reserve Account.

Under the proposal, the term "qualified security" would be amended to include an unaffiliated money market fund that (i) is described in Rule 2a-7 of the Investment Company Act; (ii) invests solely in U.S. Treasury Securities, (iii) agrees to redeem fund shares in cash no later than the business day following a redemption request by a shareholder, and (iv) has an amount of net assets equal to at least 10 times the value of the shares deposited by the broker-dealer in its customer Reserve Account.

The SEC believes this proposal would alleviate the operational burdens associated with actively managing a portfolio of U.S. Treasury Securities, and decrease the burden on broker-dealers impacted by the proposal describe above in Section III.B.2. with respect to Reserve Account cash deposits in affiliate and non-affiliate banks.

## 4. Allocation of Customer Fully Paid and Excess Margin Securities to Short Positions

As noted in Section III.A., the customer protection rule requires broker-dealers to have possession or control of all fully paid and excess margin securities of their customers. The rule also sets forth the steps a broker-dealer must take to retrieve such securities if a shortfall arises. These requirements are intended to ensure that customer securities are available to be returned to the customer in the event the broker-dealer fails.

<sup>13</sup> See Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Raymond J. Hennessy, Vice President, NYSE, and Thomas Cassella, Vice President, NASD Regulation, Inc. (Nov. 10, 1998), available at <http://www.sec.gov/divisions/marketreg/mr-noaction/nysenasd110398-out.pdf>.

<sup>14</sup> See Petition for Rulemaking No. 4-478 (April 3, 2003), as amended (April 4, 2005), available at <http://www.sec.gov/rules/petitions/petn4-478.htm>.

Currently, however, the customer protection rule does not require a broker-dealer to reduce customer fully paid and excess margin securities to its possession or control when a short position on the broker-dealer's stock record allocates to a customer long position (*e.g.*, if the broker-dealer sells short a security to its customer). Instead, the broker-dealer is permitted to put the mark-to-market value of the security as a credit item in the Reserve Formula, which, under certain circumstances, could permit the broker-dealer to use the customer's assets for proprietary purposes. For example, if the increased Reserve Account deposit requirement associated with the customer's purchase is less than the cash paid by the customer to purchase the security, the broker-dealer could use the excess customer funds in its business operations.

To prevent broker-dealers from using customer assets in this context for proprietary purposes, which the SEC stated is contrary to the goals of the customer protection rule, the SEC proposed to require a carrying broker-dealer to reduce customer fully paid and excess margin securities allocated to proprietary or customer short positions to possession or control (*e.g.*, by borrowing equivalent securities) before the broker-dealer's short position has aged more than 10 business days, or, if the broker-dealer is a market maker, before 30 calendar days.

## 5. Treatment of Free Credit Balances

"Free credit balances" under the customer protection rule are funds payable by a broker-dealer to its customers on demand. For example, free credit balances include cash deposited by a customer to purchase securities and proceeds from the sale of securities or other assets held in the customer's account. Broker-dealers may pay interest to customers on their free credit balances, or offer to sweep them into a money market fund or interest bearing bank account.

In the Release, the SEC noted that in recent years, a number of broker-dealers have changed the products to which a customer's free credit balances are swept – most frequently from a money market fund product to an interest bearing bank account. Without judging the appropriateness of the products, the SEC indicated that consequences to the customer may result from such changes, including the interest earned by the customer and the protections afforded to the customer in the event of an insolvency (*e.g.*, by the Federal Deposit Insurance Corporation, in the case of bank accounts, and by SIPC, in the case of securities accounts).

To ensure that customers are aware of the treatment of their free credit balances at a broker-dealer, the SEC proposed to require broker-dealers (i) to agree with the customer (*e.g.*, in an account opening agreement) that the broker-dealer could switch the sweep option; (ii) to provide the customer with notices and disclosures involving the investment and deposit of free credit balances required by the SROs of which the broker-dealer is a member;<sup>15</sup> (iii) to provide notice in customer account statements at least quarterly that the money market fund or bank deposit account can be liquidated on the customer's demand and converted back into free credit balances held in the customer's securities account; and (iv) to provide the customer with notice at least 30 calendar days before changing the product, the product type, or the terms and conditions under which the free credit balances are swept. If this amendment is adopted as proposed, the first condition would not apply to a broker-dealer's existing customers at the time of adoption.

The SEC also is proposing to make it unlawful for a broker-dealer to convert, invest or otherwise transfer free credit balances except upon a specific order, authorization, or draft from the customer, and only under the terms and conditions specified by the customer in the order, authorization or draft.

## 6. Elimination of Exchange Act Rule 15c3-2

The SEC proposed to eliminate Exchange Act Rule 15c3-2, and to import certain requirements of that rule into the customer protection rule. The effect of this proposal would be to eliminate the requirement that broker-dealers provide quarterly notice to customers that their funds are not being segregated and are being used in the broker-dealer's business. The SEC believes that such notice is no longer necessary because of the customer safeguards contained in the customer protection rule, which was adopted eight years after Rule 15c3-2. Requirements that broker-dealers inform customers at least quarterly of the amounts due to them and that such amounts are payable on demand, however, will be imported into the customer protection rule from Rule 15c3-2.

## 7. Aggregate Debit Items Charge

Note E(3) to the Reserve Formula requires a broker-dealer using the basic method of computing net capital to reduce

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<sup>15</sup> See, *e.g.*, NYSE Information Memo 05-11 (Feb. 15, 2005), available at [www.nyse.com](http://www.nyse.com).

by 1% the total debits in Item 10 of the Reserve Formula (*i.e.*, debit balances in customer cash and margin accounts). This 1% reduction in Item 10 debits lowers the amount of total debit items in the Reserve Formula, which, in turn, has the potential to increase the amount a broker-dealer must maintain in its Reserve Account. Alternative standard firms, however, must reduce aggregate debit items by 3% under paragraph (a)(1)(ii)(A) of the net capital rule, which can result in an even larger deposit requirement to the Reserve Account. This percentage differential is the result of historical differences in how the financial responsibility rules have applied to broker-dealers computing net capital under the two different standards. For example, between 1975 and 1992, broker-dealers under the alternative standard were subject to 15% haircuts on proprietary positions in equity securities, while broker-dealers under the basic standard were subject to 30% haircuts. This reduced haircut applicable to alternative standard firms was one of the justifications for subjecting such firms to a greater percentage deduction from aggregate debit items. The 30% haircut for basic standard firms, however, was reduced to 15% in 1992.

In the Release, the SEC stated that it has observed a substantial increase in the amount of debit items carried by broker-dealers. Consequently, the 3% reduction in debit items in the Reserve Formula has required many broker-dealers using the alternative standard to increase their Reserve Account deposits by amounts far in excess of the cushion envisioned by the SEC when the amendment was adopted in 1975. Further, the SEC stated in the Release that it has determined that the 15% haircut for equity securities has proven sufficient to cover most market moves, and, therefore, the increased level of protection derived from the greater 3% debit item reduction likely does not provide a benefit justified by the costs.

Based on the foregoing, the SEC proposed to eliminate the requirement in paragraph (a)(1)(ii)(A) of the net capital rule that requires a broker-dealer computing net capital under the alternative standard to reduce its aggregate debit items by 3% when determining how much to deposit to its Reserve Account, which would make alternative standard firms subject to the 1% reduction in debit items required by Note E(3). This proposal would benefit broker-dealers subject to the 3% reduction by potentially reducing their Reserve Account deposit requirements, which, in turn, would free up capital.

## 8. Treatment of Funds in Proprietary Commodity Accounts

According to the SEC, a question has arisen as to whether broker-dealers also registered as futures commission merchants with the CFTC must include funds carried in a "proprietary account," as that term is defined in CFTC Rule 1.3(y) ("Rule 1.3(y) proprietary accounts"),<sup>16</sup> as free credit balances under Rule 15c3-3. Under Rule 15c3-3, funds carried in commodities accounts that are segregated in accordance with Commodity Exchange Act ("CEA") requirements are not considered free credit balances. Funds in Rule 1.3(y) proprietary accounts, however, are not segregated under CEA requirements, and, because Rule 15c3-3 does not specifically address how funds in such accounts should be treated, may be deemed free credit balances.

Because funds in Rule 1.3(y) proprietary accounts are not likely to be protected in a SIPA proceeding, and the Reserve Account deposit requirements in Rule 15c3-3 are intended to satisfy customer claims arising from securities (not commodities) transactions, the SEC proposed to amend Rule 15c3-3 to clarify that funds held in a Rule 1.3(y) proprietary account under CEA regulations are not to be included as free credit balances in the Reserve Formula.

## 9. Futures in Securities Portfolio Margin Accounts

Recent amendments to SRO margin rules currently permit certain broker-dealers to compute customer margin requirements using a portfolio margin methodology. A portfolio margin methodology establishes margin requirements based on the net market risk of all positions in an account assuming certain potential market movements. Under SRO portfolio margin rules, a broker-dealer can combine securities and futures positions in the portfolio margin account. SIPA, however, only protects customer claims for securities and cash and specifically excludes from protection futures contracts that are not also securities.

To provide the protections of Rule 15c3-3 and SIPA to futures positions in customer securities accounts under SRO portfolio margin rules, the SEC proposed to amend the definition of "free credit balance" in paragraph (a)(8) of Rule 15c3-3. The amendment would treat as free credit balances funds resulting from margin deposits and daily marks-to-market related to, and proceeds from the

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<sup>16</sup> 17 CFR 1.3(y).

liquidation of, futures on stock indices and options thereon carried in a securities account pursuant to a portfolio margin rule of an SRO. As free credit balances, such funds would have to be included with all other credit items when a broker-dealer makes its Reserve Formula computations under Rule 15c3-3, and, in the event a broker-dealer becomes subject to a SIPA proceeding, such funds as of the SIPA filing date would constitute claims for cash, and therefore be entitled to up to \$100,000 in advances under SIPA to make up for shortfalls.

The SEC also proposed to amend Item 14 of Rule 15c3-3a, which would permit a broker-dealer to include as a debit item in the Reserve Formula the amount of customer margin required and on deposit at a futures clearing organization related to futures positions carried in a securities account pursuant to an SRO portfolio margin rule. This amendment would make the margin required and on deposit at a futures clearing organization part of the broker-dealer's "customer property" in the event the broker-dealer is placed in a SIPA liquidation, meaning that it would be available to the liquidation trustee for distribution to the failed firm's customers.

#### IV. The Books and Records Rules

##### A. Overview of the Books and Records Rules

The SEC's books and records rules specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and certain other documents must be kept. The SEC has required that broker-dealers create and maintain certain records so that, among other things, the SEC, SROs, and state securities regulators may conduct effective examinations of broker-dealers.

##### B. Documentation of Risk Management Procedures

The SEC stated in the Release that a well-documented system of internal controls designed to manage material risk exposures enables a broker-dealer's management to identify, analyze, and manage the risks inherent in the firm's business activities with a view to prevent significant losses. The SEC also emphasized that the need for such controls is "particularly urgent" with respect to the largest broker-dealers, which generally engage in a wide range of highly complex businesses across many different markets and geographical locations.

Although the SEC stated that, for the most part, large broker-dealers as a matter of business practice already

have well-documented procedures and controls for managing risks, it proposed to add paragraph (a)(23) to Rule 17a-3, which would require certain large broker-dealers to document any implemented internal risk management control designed to assist in analyzing and managing the risks (*e.g.*, market, credit, liquidity, and operational risks) arising from the business activities it engages in, including, for example, securities lending and repo transactions, OTC derivative transactions, proprietary trading, and margin lending. The requirement, which would not impose any minimum elements to be included in a firm's internal controls, only would apply to broker-dealers that have more than \$1 million in aggregate credit items as computed under the Reserve Formula, or \$20 million in total capital including debt subordinated in accordance with Appendix D to Rule 15c3-1.

The proposal also would add paragraph (e)(9) to Rule 17a-4, which would require a broker-dealer to maintain these records for three years after the date the broker-dealer ceases to use the system of controls. The SEC said that the additional three years creates an audit trail between former and current procedures and provides regulators with sufficient opportunity to review the records during the broker-dealer's normal exam cycle.

#### V. Additional Requests for Comment

In addition to requesting comment on any aspects of the proposed amendments described above, the SEC also requested comment on certain specific matters described below.

##### A. Early Warning Levels

The Securities Industry and Financial Markets Association ("SIFMA") has proposed to the SEC that it lower the broker-dealer "early warning level" (*i.e.*, the level at which a broker-dealer must notify regulators about its financial condition) for firms that carry over \$10 billion in debits. Currently, under Rule 17a-11, a broker-dealer that computes its net capital requirement using the alternative standard must provide regulators with notice if their net capital level falls below 5% of aggregate debit items. SIFMA contends that a broker-dealer with aggregate debit items exceeding \$10 billion would not be approaching financial difficulty simply because its net capital falls to the 5% early warning threshold. The SEC seeks comment on the SIFMA proposal, and whether it would be appropriate to adopt a tiered and less stringent early warning level for these larger broker-dealers. The tiered early warning level

suggested by SIFMA would be calculated by adding 5% of the first \$10 billion in debits + 4% of the next \$5 billion + 3% of the next \$5 billion + 2.5% of all remaining debits.

### B. Harmonizing Securities Lending and Repo Charges

Securities lending and borrowing transactions are economically similar to repurchase and reverse repurchase transactions. The need to take a deduction (or the size of the deduction) under Rule 15c3-1 may depend, however, on whether the broker-dealer executes the transaction as a securities loan/borrow or repurchase/reverse repurchase transaction. In order to eliminate this mismatch, the SEC seeks comment on the feasibility of making identical the net capital deductions for these economically similar transactions.

### C. Accounting for Third Party Liens on Customer Securities

The SEC also seeks comment on how third-party liens against customer fully paid securities carried by a broker-dealer should be treated under the financial responsibility rules (*e.g.*, whether a broker-dealer should be required to include the amount of the customer's obligation to the third-party as a credit item in the Reserve Formula).

## VI. Observations

The SEC's proposed amendments are likely to affect most broker-dealers, albeit to a varying extent. While a number of the proposals, if adopted, will lessen the regulatory costs associated with operating a broker-dealer (*e.g.*, by reducing net capital and Reserve Account deposit requirements), others have the potential to increase such costs (*e.g.*, by imposing new net capital charges and limiting where Reserve Account deposits may be made). Several of the proposals also attempt to codify existing SEC and SEC staff positions, and, as a result, provide a long-awaited opportunity to comment on and possibly modify those positions. It is important to be familiar with each of the proposals described above in order to adequately evaluate whether the costs and benefits relating to a proposal are significant enough to justify a comment thereon, and we have prepared this summary to assist you in making an informed evaluation.

There are two particularly significant proposals. First, the SEC's proposed amendments relating to portfolio margining further support the industry's efforts to promote cross-margining of securities and futures in a portfolio margin account. Second, the SEC's proposal requiring that

certain broker-dealers establish a well-documented system of internal controls for managing risk also will likely generate a significant dialogue, ranging from requests to modify the scope of firms covered by the proposal – arguing that a \$20 million capital threshold is too low – to requests for additional guidance on what information will suffice to avoid regulatory scrutiny.

Of all of the proposals, the SEC's attempt to limit the banks where Reserve Account deposits may be held may prove highly controversial. This proposal has the potential to adversely affect firms that currently meet their Reserve Account deposit requirements at affiliated and unaffiliated banks by requiring such firms to open new bank accounts or substitute qualified securities for cash in an existing Reserve Account.<sup>17</sup> Expanding the definition of the term "qualified securities" to include money market funds also is likely to be a sensitive issue. Although this proposal is viewed as a significant loosening of current risk controls by certain members of the SEC and SEC staff, there will likely be several proponents in favor of broadening the proposal. To the extent the definition as proposed is acceptable, comments to this effect may prove beneficial in avoiding delay in the proposed amendment's adoption.

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<sup>17</sup> Reducing the amount on deposit at a bank has the potential to impact the rate of return the bank is willing to pay on funds deposited with the bank, and investing in qualified securities requires additional human and financial resources dedicated to overseeing the investment function.

## For Further Information

If you have any questions concerning this Regulatory Update, or if you would like to discuss preparing a comment letter on the SEC's proposed rules, contact any of the following members of our Securities and Futures Market Regulation Group:

### Washington, D.C.

Mark M. Attar	mattar@schiffhardin.com	t 202.778.6427
Joseph P. Corcoran	jcorcoran@schiffhardin.com	t 202.778.6432
Andrew M. Klein	aklein@schiffhardin.com	t 202.778.6415
Howard L. Kramer	hkramer@schiffhardin.com	t 202.778.6414
Laura S. Pruitt	lpruitt@schiffhardin.com	t 202.778.6470

### Atlanta

Matthew H. Baughman	mbaughman@schiffhardin.com	t 404.437.7025
Ethan H. Cohen	ecohen@schiffhardin.com	t 404.437.7033
Wendy B. Hart	whart@schiffhardin.com	t 404.437.7019
Michael K. Wolensky	mwolensky@schiffhardin.com	t 404.437.7030

### Chicago

Paul E. Dengel	pdengel@schiffhardin.com	t 312.258.5614
Stacie R. Hartman	shartman@schiffhardin.com	t 312.258.5607
Allan Horwich	ahorwich@schiffhardin.com	t 312.258.5618
Paul E. Greenwalt III	pgreenwalt@schiffhardin.com	t 312.258.5702
Michael L. Meyer	mmeyer@schiffhardin.com	t 312.258.5713
Carl A. Royal	croyal@schiffhardin.com	t 312.258.5707
Robert B. Wilcox Jr.	rwilcox@schiffhardin.com	t 312.258.5590

### New York

Robert J. A. Zito	rzito@schiffhardin.com	t 212.745.0827
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### San Francisco

John S. Worden	jworden@schiffhardin.com	t 415.901.8764
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